

**State Investment Commission**  
**Minutes**  
**March 29, 2005**

The State Investment Commission was called to order by Jonathan Miller, State Treasurer, on Tuesday, March 29, 2005 in Room 264 of the Capitol Annex at 10:00 a.m. Members present were John Farris, Proxy for Robbie Rudolph, Secretary, Finance and Administration Cabinet; Michael Alexander, proxy for Governor Ernie Fletcher; and Jonathan Miller, State Treasurer.

Treasurer Miller verified that a quorum was present and that the press had been notified of the meeting.

A motion was made by Mr. Alexander and seconded by Mr. Farris to accept the minutes of the December 21, 2004 meeting. Motion **CARRIED**.

Dwight Price, Portfolio Manager, Office of Financial Management, indicated that it was necessary to change the trading limits of the individuals in the investment section. Mr. Price indicated that Kim Bechtel would be investing in asset backed and mortgage backed securities in the money market arena. He also indicated that the limits for Steve Jones and him were being changed to add money market securities.

A motion to approve the trading limits of the investment staff was made by Mr. Alexander and seconded by Mr. Farris. Motion **CARRIED**.

Mr. Price indicated that staff has reviewed responses to the securities lending Request for Proposals and have selected Credit Suisse First Boston as the securities lending provider. Mr. Price indicated that the Commonwealth would realize 80 percent of the profit under their proposal rather than the 75 percent realized in previous years. Mr. Price stated that when interest rates rise, spreads will be better and the Commonwealth should receive higher profits.

Treasurer Miller asked if interest rates were expected to continue to rise. Mr. Price indicated that it is expected that short-term interest rates will climb between 3.75 percent to 4.00 percent.

Mr. Steve Jones, Portfolio Manager, Office of Financial Management, stated it is possible that the Fed may begin to move interest rates earlier than anticipated. Mr. Jones indicated that employment numbers should be released within the next few days and would affect the movement of interest rates. Treasurer Miller asked if the increase in the interest rate would be beneficial to the Commonwealth. Mr. Price indicated that as interest rates go up, the value of the securities that the Commonwealth owns would decrease. Mr. Price indicated, however, that if the securities were reinvested, they would be reinvested at a higher rate that will result in a higher return for the Commonwealth.

Mr. Jones presented an update on the TRAN (Tax and Revenue Anticipation Notes) through February 28, 2005. Mr. Jones indicated that at the beginning of the current fiscal year, the Commonwealth borrowed \$500,000,000 and executed an interest rate swap to manage the interest rate risk. Mr. Jones indicated the Note was fixed rate. Mr. Jones further stated that the swap

synthetically changed the fixed rate to a floating rate. Proceeds from the note issuance were invested in floating rate assets. Mr. Jones indicated that the Commonwealth realized a profit of \$198,184.51 through the end of February 2005 on the floating side of the swap versus the assets. Mr. Jones stated the original projection was zero by the end of the year. Mr. Jones continued that on the fixed side of the swap versus the fixed payment on the debt, the Commonwealth has realized a profit of \$1.8 million year to date for total combined earnings of approximately \$2 million. Mr. Jones projected earnings at the end of the year would be near \$3 million after the notes mature. Mr. Jones continued that if the 5 basis point fee that the Office of Financial Management charges for managing the assets were considered, the total amount earned will be over \$3 million.

Treasurer Miller asked if the investment staff keeps the Consensus Forecasting Group informed of the projected earnings on the transaction. Mr. Price indicated that the Consensus Forecasting Group was aware of the projected earnings.

Mr. Jones reviewed the Interest Rate Straddle that was discussed at the December 2004 meeting. In December, staff indicated that spreads in volatility were low but were expected to increase so they entered into a trade (interest rate straddle) that would earn money if volatility increased. Mr. Jones indicated that the straddle is two swaptions (call options on interest rate swaps) which gave staff the right to enter into a swap. Mr. Jones stated that the swaption was purchased for \$957,500 and as of this date the swaption was worth \$979,000. Mr. Jones noted that the handout shows the value of the swaption as volatility and interest rates change.

Mr. Price indicated that the straddle is used as a hedge because the portfolio tends to be in spread products (callable agency securities etc.) and we are short volatility. Mr. Price continued that if volatility increases, it offsets a loss to the portfolio. Mr. Price said if the hedge does not make money, the portfolio hasn't lost money.

Mr. Price indicated that historically the banking contract included custodial services for securities purchased by the Commonwealth and that the administrative regulations provide for the state depository bank to monitor the collateral for linked deposits. Mr. Price informed the Commission that the banking contract was split into two separate components (banking and custody) and monitoring the collateral was included in the RFP for custody services. Mr. Price indicated that this would require a change to the administrative regulations to reflect that monitoring will be part of custody services.

Mr. Price stated that the Commonwealth's corporate securities include puttable bonds. He further stated that the final maturity for a corporate security is five years. Mr. Price indicated that there are some bonds in the market that have ten year maturities, but in three years they can be put back to the issuer, which makes the duration three years instead of ten. Mr. Price proposed to change the administrative regulations to allow staff to invest in those types of puttable securities.

Treasurer Miller asked who was awarded the contract for custody services. Mr. Price indicated that U. S. Bank was selected to provide those services to the Commonwealth.

Mr. Jones indicated that staff has been working with the Kentucky Housing Corporation in an effort to hedge their mortgage pipeline. Mr. Jones stated that the Kentucky Housing Corporation provides low interest mortgage loans to low-to-moderate income families by selling bonds. He indicated that there is a lapse between the time the loans are made and the bonds are issued in which interest rates can fluctuate. Mr. Jones indicated that staff is working on a program that will include interest rate swaps to effectively lock in the price of the debt at the same time the Corporation is making mortgage loans.

Mr. Jones stated that previously he informed the Commission that he would not be working with Hilliard Lyons due to a conflict of interest. Mr. Jones informed the Commission that his wife no longer worked for Hilliard and the conflict no longer exists.

Treasurer Miller asked if there was any other business before the Commission. There was no further business before the Commission and the meeting was adjourned.

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Secretary  
State Investment Commission